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No. 92-1370

IN THE
# Supreme Court of the United States
OCTOBER TERM, 1993

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BFP, a Partnership,
*Petitioner,*
v.
RESOLUTION TRUST CORPORATION, as Receiver for Imperial Federal Savings Association, *et al.*,
*Respondents.*

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**On Writ of Certiorari to the United Sttaes Court of Appeals for the Ninth Circuit**

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## BRIEF FOR AMICI CURIAE FEDERAL HOME LOAN MORTGAGE CORPORATION, MORTGAGE BANKERS ASSOCIATION OF AMERICA, SAVINGS & COMMUNITY BANKERS OF AMERICA, AND AMERICAN LAND TITLE ASSOCIATION IN SUPPORT OF RESPONDENTS

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## QUESTION PRESENTED

Whether the consideration received from a noncollusive foreclosure sale that is conducted in conformance with applicable state law constitutes "reasonably equivalent value" under 11 U.S.C. 548(a)(2)(A).

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Amici Curiae Federal Home Loan Mortgage Corporation ("Freddie Mac"), the Mortgage Bankers Association of America ("MBAA"), the American Land Title Association ("ALTA"), and the Savings and Community Bankers Association ("SCBA") (collectively, the "Amici"), agree with Respondents that the United States Court of Appeals for the Ninth Circuit correctly held that the price received at a noncollusive, regularly conducted foreclosure sale satisfies the reasonably equivalent value requirement of 11 U.S.C. section 548(a)(2)(A), as a matter of law.

## STATEMENT OF INTEREST OF AMICI CURIAE

The Amici represent a broad cross-section of participants in the mortgage lending and land title industries. The Amici have joined in this brief because of our strong belief that affirmance of the decision below is necessary to ensure certainty and finality in real estate transactions.

Freddie Mac is a corporate instrumentality of the United States, chartered by Congress. Its statutory mission is to foster and promote a secondary market for the purchase and sale of mortgages on residential real estate. Freddie Mac acts in the secondary mortgage market to increase the liquidity of mortgage investments and thereby make more capital available for home financing. Banks, savings associations and other lenders originate loans on the primary mortgage market, and then sell those loans on the secondary mortgage market to Freddie Mac and others. Freddie Mac, in turn, resells interests in these mortgages to investors in the form of mortgage pass-through securities. However, Freddie Mac remains the mortgagee on the loans which are serviced by a network of local servicing banks. With the funds received from the sale of mortgage-backed securities, Freddie Mac purchases more mortgages from originating lenders who in turn make those funds available to home purchasers. The secondary mortgage market thus greatly increases the supply, and reduces the cost, of home mortgage credit to America's homeowners. To date, Freddie Mac has provided the financing for approximately one in six American homes.

The smooth functioning of the secondary mortgage market depends upon a predictable flow of principal and interest from home mortgages. Freddie Mac has a particularly strong interest in the outcome of this case since it is the mortgagee in a substantial number of single family and multifamily foreclosures each year.



MBAA is a non-profit corporation headquartered in Washington, D.C. and existing under the General Not for Profit Corporation Act of Illinois. MBAA is the primary national trade association devoted to the field of mortgage and real estate financing. Mortgage banking firms, which comprise the largest part of MBAA's total membership of 2,600 corporations, engage in originating, financing, selling and servicing both residential and commercial mortgages. "Origination" is the process of negotiating, arranging, and funding the loan to home buyers. "Servicing" is the collection of payments on existing loans, monitoring the payment of real property taxes and other charges, and facilitating the realization of the security in the event of nonpayment. In 1992, mortgage bankers originated more than $400 billion in single-family mortgages and serviced in excess of $1 trillion in single-family mortgages. MBAA members also originated $10.2 billion in mortgage loans on commercial real estate and serviced in excess of $155 billion in commercial real estate mortgages in 1992. MBAA's interest in this case is based on its members' participation in many aspects of the mortgage industry including foreclosure proceedings.

The Savings & Community Bankers of America ("SCBA") is a national trade association representing approximately 1,900 depository institutions involved in residential mortgage lending. SCBA was formed in 1993 through a merger of the former National Council of Community Bankers and the United States League of Savings Institutions. Member institutions are federal and state-chartered, stock and mutually owned, and insured by the Federal Deposit Insurance Corporation. SCBA members are major originators of one-to-four family home loans, some of which are sold into the secondary markets while others are held as portfolio investments.

The American Land Title Association ("ALTA") is the national trade association of the land title industry. ALTA has approximately 2,300 members, including land title insurers, title insurance agents, abstracters, and as-

sociate members. The principal function of the land title industry is to facilitate the safe, certain, and efficient transfer of title to real estate in both residential and commercial transactions by ascertaining and insuring the rights of purchasers, mortgage lenders, and others involved in real estate transactions. ALTA's interest in this case arises from the interest of its members in the certainty and predictability of laws affecting title to and rights in real estate.

## SUMMARY OF ARGUMENT

Section 548(a)(2) of the Bankruptcy Code, 11 U.S.C. section 548(a)(2), grants to a trustee or debtor-in-possession the power to avoid certain transfers made within one year before the date of filing of the bankruptcy petition if the debtor "received less than reasonably equivalent value in exchange for such transfer or obligation." [1] The issue before the Court which has divided the circuits is the proper application of section 548(a)(2) to a noncollusive public foreclosure conducted in conformance with the requirements of applicable state law.[2]

[1] Section 548 provides, in pertinent part:

> (a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor . . .
>
> (2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
>
> (B)(i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation . . .

11 U.S.C. section 548(a).

[2] The Ninth and Sixth Circuits follow the rule that is the subject of this appeal. The so-called *Madrid* rule holds that the value obtained at a noncollusive foreclosure sale conducted in accordance with state law conclusively establishes reasonably equivalent value under section 548(a)(2). *See In re Madrid*, 21 B.R. 424 (Bankr. 9th Cir. 1982), *aff'd on other grounds*, 725 F.2d 1197 (9th Cir.), *cert. denied*, 469 U.S. 833 (1984); *In re Winshall Settlor's Trust*, 758 F.2d 1136 (6th Cir. 1985). The Fifth Circuit in *Durrett v. Washington National Insurance Co.*, 621 F.2d 201 (5th Cir. 1980) took the position that a foreclosure sale can be overturned under section 548 if the price is not sufficiently close to the fair market value, and noted that it could find no cases that had approved such a sale for less than 70% of market value. The 70% benchmark has become widely known as the "*Durrett*" rule. A third approach (really a variation on *Durrett*) was taken by the Seventh Circuit in *Bundles v. Baker (In re Bundles)*, 856 F.2d 815 (7th Cir. 1988), which held that reasonable equivalence should depend on all the facts and circumstances of each case, but that normally there is a strong presumption that the foreclosure sale price is reasonably equivalent value. The *Bundles* rule has been followed in three other circuits. *See Barrett v. Commonwealth Federal Savings & Loan*, 939 F.2d 20 (3d Cir. 1991); *Cooper v. Ashley Communications Inc. (In re Morris Communications NC, Inc.)*, 914 F.2d 458 (4th Cir. 1990); *Grissom v. Johnson (In re Grissom)*, 955 F.2d 1440 (11th Cir. 1992).



The petitioner contends that section 548(a)(2) requires a bankruptcy court, in every case, to conduct a valuation hearing to determine whether the foreclosure sale price was reasonably equivalent to the "true value" of the property. The Amici submit that provided the foreclosure sale is regularly conducted and noncollusive such a hearing is unwarranted. Where a debtor has defaulted on its mortgage loan, foreclosure is the bargained for process by which the "true value" of the property is determined in the market place.

From the perspective of all parties—secured creditors, debtors and unsecured creditors—allowing bankruptcy courts to undo valid foreclosure sales based on a case-by-case determination of "reasonably equivalent value" is highly undesirable. As the Ninth Circuit Court of Appeals stated below, such a practice "carries with it the strong potential to destabilize state mortgage transactions" and "produces intolerable uncertainty regarding the finality of any purchase at a foreclosure sale even if the price paid at the sale is close to, but not equal to, the retail market value." *In re BFP*, 974 F.2d 1144, 1148 (9th Cir. 1992), quoting S. Erlich, *Avoidance of Foreclosure Sales as Fraudulent Conveyances: Accommodating State*

*and Federal Objectives,* 71 Va.L.Rev. 933, 963-64 (1985).

Nothing in the statute, legislative history, or general principles of law precludes the court below from fashioning a conclusive rule that, in the absence of fraud, collusion or procedural defects, the foreclosure sale price constitutes reasonably equivalent value. *See Madrid v. Lawyers Title Insurance Corp. (In re Madrid),* 725 F.2d 1197, 1204 (9th Cir.), *cert. denied,* 469 U.S. 833 (1984). The lack of a statutory provision allocating the burden of proof on this matter only establishes that Congress left the field open to the courts. *See Cooper v. Ashley Communications, Inc. (In re Morris Communications NC, Inc.),* 914 F.2d 458, 466 (4th Cir. 1990). The application of section 548 to unwind foreclosure sales that conform to all requirements of state law has undeniable negative economic consequences, undermines the public policy favoring free alienation of land and finality and certainty in real estate transactions, creates anomalous results and inconsistency within the Bankruptcy Code, wastes judicial resources, and is unnecessary to the protection and preservation of equity. Thus, the conflict among the courts of appeal should be resolved by affirmance of the Ninth Circuit's decision below.



## ARGUMENT

### I. THE AMOUNT REALIZED AT A NONCOLLUSIVE, REGULARLY CONDUCTED FORECLOSURE SALE SATISFIES THE REASONABLY EQUIVALENT VALUE REQUIREMENT OF SECTION 548.

The Ninth Circuit Court of Appeals correctly concluded that the amount realized at a noncollusive, regularly conducted foreclosure sale satisfies the reasonably equivalent value requirement of section 548. Petitioner and its amici argue that the plain meaning of "reasonably equivalent value" is "fair market value." However, many courts have pondered the meaning of reasonable equivalence, but all agree that reasonable equivalence is not wholly synonymous with market value. *See Morris Communications,* 914 F.2d at 466, and cases cited therein. As the Seventh Circuit noted, "If anything is clear from the various uses of the word 'value' in the Code, it is that Congress did not mean fair market value when it used 'reasonably equivalent value.'" *Bundles v. Baker (In re Bundles),* 856 F.2d 815, 824 (7th Cir. 1988).

The term "fair market value" appears in two other provisions of the Bankruptcy Code,[3] but was rejected by Congress in enacting section 548. Fair market value has a common, well-understood meaning, which may be subject to minor regional variations, but which in essence means the price for which the property will sell in a transaction between a willing buyer and a willing seller, each acting prudently, knowledgeably, in their own self-interest, and under no compulsion to buy or sell.[4] In short, fair

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[3] *See* 11 U.S.C. section 522(a) (property exempted from debtor's estate) and 11 U.S.C. section 346(j)(7)(B) (excluding from discharge certain indebtedness that is exchanged for an equity contribution under a plan).

[4] *See e.g.* American Institute of Real Estate Appraisers, *The Appraisal of Real Estate,* 8th ed. (Chicago: American Institute of Real Estate Appraisers, 1983), p. 33.

market value means the price that can be obtained under ideal sale conditions.

By opting for reasonably equivalent value instead of fair market value, Congress necessarily required a court applying section 548 to accept a lesser value. A foreclosure sale does not involve a willing seller under no compulsion to sell. Thus, a foreclosure sale does not provide the ideal sales conditions embraced in the definition of fair market value. Moreover, property being sold at foreclosure is typically in a distressed condition. The "true value" of distressed property sold at foreclosure is the highest bid obtained under forced-sale public auction conditions. Where a debtor has defaulted on its mortgage loan, foreclosure is the bargained for process by which the value of the collateral is determined in the market place. Therefore, the foreclosure sale price should be deemed to be reasonably equivalent value provided the sale is noncollusive and comports with all applicable state law requirements.

The price bid at a regularly conducted noncollusive foreclosure sale is the best evidence of reasonably equivalent value given the nature of the transaction. Initial lender notices of nonpayment and subsequent state law foreclosure procedures provide the defaulting borrower many months to seek refinancing or to sell the property. If the property had value in excess of outstanding debt, it would attract new financing and the foreclosure would not occur. The failure of the borrower to sell or refinance conclusively establishes that there is no equity to be recovered under section 548. *See* Part IV, *infra*.

The term "reasonably equivalent value" is a term of art not defined in the Bankruptcy Code. However, that does not mean as petitioner's amici assert that the common separate dictionary meaning of each word must be employed without regard to the legal context of section 548. The term "reasonably equivalent value" first appeared in 1978 when section 548 of the Bankruptcy Code



replaced section 67(d)(2) of the Bankruptcy Act of 1898 which used the term "fair consideration."[5] There is no legislative history to illuminate the 1978 change, but commentators have suggested that the new phraseology was part of an attempt to remove subjective considerations such as good faith from the criteria for the avoidance of fraudulent transfers. *See* Erlich, *supra* at 944-53. As a result, it is fair to conclude that the scope and meaning of the term "reasonably equivalent value" was left to the courts, *Morris Communications*, 914 F.2d at 466, and that an objective test such as compliance with state foreclosure procedures best implements Congressional intent.

Nor does the legislative history of the 1984 amendments to section 548 support equating reasonably equivalent value with fair market value.[6] At the worst, the

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[5] Section 67(d)(2) of the Bankruptcy Act provided that "Every transfer made . . . by a debtor within one year prior to the filing of a petition . . . is fraudulent . . . if made or incurred without fair consideration by a debtor who is or will be thereby rendered insolvent, without regard to his actual intent . . ." Under section 67(d)(1)(e), consideration was deemed to be fair if "when, in good faith, in exchange and as fair equivalent therefor, property is transferred or an antecedent debt is satisfied." *See* 11 U.S.C. section 107(d)(1)(e) and (d)(2) (1976) (repealed 1978).

[6] The Bankruptcy Amendments and Federal Judgeship Act (BAFJA) was enacted on July 10, 1984, and became effective on October 8, 1984. BAFJA proposed three changes to the Bankruptcy Code to address the *Madrid/Durrett* problem: (i) amending the definition of "transfer" in section 101 to cover "foreclosure of the debtor's equity of redemption;" (ii) amending section 548 to clarify its applicability to voluntary or involuntary transfers; and (iii) granting an irrebutable presumption of reasonably equivalent value to a mortgage or third party purchaser at a regularly conducted noncollusive foreclosure sale who paid a price at least equal to the amount of the mortgage debt. Only the first two changes became law. The third change was deleted at the request of Senator Metzenbaum who objected to resolving the *Madrid/Durrett* issue at that time because it had not been considered in committee. *See In re Verna*, 58 B.R. 246, 250 (Bankr. C.D. Cal. 1986).

legislative history is inconclusive. At best, it confirms that the 1984 amendments were intended neither to overrule *Madrid*, nor to cast a cloud over noncollusive foreclosure sales. Jurists and scholars have debated the weight, if any, that should be given a scripted colloquy between Senators Dole and DeConcini which occurred after passage of the 1984 amendments to section 548 to the effect that those amendments were not intended to deal with the question of whether noncollusive regularly conducted foreclosure sales should be deemed to be for a reasonably equivalent value. *See Bundles*, 815 F.2d at 821; *In re Verna*, 58 B.R. 246, 250-251 (Bankr. C.D. Cal. 1986) (Congress took no position on the reasoning in *Madrid*); F. Kennedy, *Involuntary Fraudulent Transfers*, 9 Cardozo L.Rev. 531, 566 (1987); R. Zinman, *Noncollusive, Regularly Conducted Foreclosure Sales: Involuntary Nonfraudulent Transfers*, 9 Cardozo L. Rev. 581, 592-594 (1987). Regardless of whether the Senatorial comments are legislative history in the technical sense, they are insightful because they do not attempt to undo what was written, but rather confirm that the legislative intent was neither to support *Durrett* nor to overrule *Madrid*.[7] *Id.* at p. 594, n.58.

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[7] The text of the colloquy, in pertinent part, is as follows: Mr. DeCONCINI: Apparently there may have been some misunderstanding regarding the effect of certain technical amendments made by the recently enacted bankruptcy legislation . . . A question has arisen whether these amendments somehow support the position taken . . . in *Durrett* . . . . My understanding is that these provisions were not intended to have any effect one way or the other on the so called *Durrett* issue. Is my understanding correct?

Mr. DOLE: The Senator's understanding is indeed correct. . . . Consequently, no provision of the bankruptcy bill passed by this body was intended to intimate any view one way or the other regarding the correctness of the position taken . . . in the *Durrett* case, or regarding the correctness of the position taken by . . . *Madrid*, . . . . which reached a contrary result. . . . [T]he amendment should not be construed to in anyway codify *Durrett* or throw a cloud over noncollusive foreclosure sales. . . . Finally, neither of the [amendments] purport to deal with the question of whether a noncollusive, regularly conducted foreclosure sale should be deemed to be for a reasonably equivalent value.

Mr. DeCONCINI: Then I am correct in concluding that parties in bankruptcy proceedings who seek avoidance of prepetition foreclosure sales would find no support for their arguments in these amendments?

Mr. DOLE: The Senator's conclusion is correct.

*Bundles v. Baker (In the matter of Bundles)*, 856 F.2d 815, 821 n.8 (7th Cir. 1988), *quoting* 130 Cong. Rec. S. 13,772 (No. 131, Pt. II, Oct. 5, 1984).



Petitioner's amici suggest that several cases not involving real estate foreclosure sales show that reasonably equivalent value should be equated with fair market value. However, the meaning of the reasonably equivalent value requirement can only be determined in the context of the paritcular *type* of transaction being scrutinized. That is, whether real estate foreclosure sales satisfy the reasonably equivalent value requirement cannot be determined by examining transactions involving other forms of property. Real estate foreclosure laws provide a unique set of procedural protections which, in the absence of fraud or collusion, establish *ipso facto* reasonably equivalent value. *See* Part IV, *infra*. All of the cases cited by petitioner's amici are either distinguishable on their facts or simply inapposite to the precise question presented to this Court.[8]

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[8] *Gray v. Snyder*, 704 F.2d 709 (4th Cir. 1983) involved valuation of a duty of support under a divorce settlement rather than the valuation of a fungible asset. In *Covey v. Commercial Nat'l Bank*, 960 F.2d 657 (7th Cir. 1992), a secured creditor seized and actually sold certain equipment for an amount in excess of its debt; court was not asked to speculate as to the "true value" of the assets. *In re Ozark Restaurant Equip. Co.*, 850 F.2d 342 (8th Cir. 1988) is a case of actual fraud involving a discounted sale of assets by the debtor to an insider. In *In re McConnell*, 934 F.2d 662 (5th Cir. 1991), the Chapter 7 trustee recovered excessive liquidated damages which were unenforceable under state law. *In re Jeffrey Bigelow Design Group, Inc.*, 956 F.2d 479 (4th Cir. 1992) finds no fraudulent transfer where the debtor was merely repaying money it had received on a line of credit. *In re Abbott's Dairies*, 788 F.2d 143 (3rd Cir. 1986) does not address section 548. Rather, it con-

## II. THE *DURRETT/BUNDLES* RULE HAS AN UNDENIABLE NEGATIVE IMPACT ON ALL PARTICIPANTS IN REAL ESTATE TRANSACTIONS.

Permitting a bankruptcy court to reexamine the facts and circumstances of a noncollusive, regularly conducted foreclosure sale to determine whether reasonably equivalent value was obtained has undeniable and unjustifiable negative effects on mortgage lenders, borrowers, title insurers, and purchasers at foreclosure sales. As a practical matter, the threat of a section 548 challenge casts a cloud of uncertainty over the title received at a foreclosure sale, discourages participation of third party purchasers at such sales, impairs the ability of the foreclosure purchaser to resell the property, and exposes the buyer to unreasonable risks if he does resell before it is certain that no such challenge can be commenced. Moreover, in the post-*Durrett* world, the purchaser at foreclosure incurs significant additional economic burdens due to the higher costs of title insurance (if he can obtain it), discounted resale prices, and an extended holding period before resale.

The principal negative effect of the *Durrett/Bundles* rule is the risk that a properly conducted foreclosure sale that comports with state law may be set aside if a bankruptcy petition is filed by the mortgagor within one year after the sale.[9] This risk erodes the essential right that

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cerned a challenge to a sale of assets under section 363 of the Bankruptcy Code on the grounds that the buyer did not purchase in "good faith." Interestingly, the *Abbott's* Court noted that if the buyer had purchased in "good faith," then the price paid is "fair and reasonable." *Id.*, 788 F.2d at 149. We note also that the interests in this case of petitioner's amici, Frank Allen and Levander and Elnora McKeever, seem remote at best. Those amici were involved in tax sales which do not afford the full procedural protections of a real estate foreclosure initiated under state law by a private mortgagee.

[9] In the event a bankruptcy petition is filed within one year of the sale, this uncertainty will continue until the bankruptcy case is closed (in some cases for several years), since a fraudulent transfer action may be initiated at any time before the earlier of two years after the appointment of a trustee or the time the case is closed or dismissed. 11 U.S.C. section 546(a). If the case is converted to Chapter 7 rather than dismissed, then provided no trustee was previously appointed, the Chapter 7 trustee will have an additional two years in which to commence a fraudulent transfer action. *See In re Bingham Systems, Inc.*, 139 B.R. 809, 812 (Bankr. N.D. Miss. 1991).



a mortgage lender relies upon for the security of its loan —the right to foreclose on the property in the event of default. The petitioner's amici characterize industry concern for this risk as "chimerical" and unsupported by empirical evidence. Petitioner's amici are simply wrong.

The risk that a valid foreclosure sale may be set aside years later by a bankruptcy court impairs the quality of title obtained at a foreclosure sale. In recognition of this fact, title insurers began writing the so-called "*Durrett* Exception" (also known as the "Creditor's Rights Exception") shortly after *Durrett* was decided. This exception excludes from coverage under title insurance policies issued to purchasers at foreclosure sales, or to their mortgage lenders, the possible claim that the foreclosure sale may be avoided under bankruptcy laws. In 1990, the American Land Title Association's form loan policy made such an exclusion standard language for all title insurance.[10]

Another well-recognized effect of the *Durrett/Bundles* rule is that potential third party buyers at foreclosure

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[10] The 1990 ALTA Loan Policy (4-6-90) excludes "[a]ny claim, which arises out of the transaction creating the interest of the mortgagee insured by this policy, by reason of the operation of federal bankruptcy, state insolvency, or similar creditor's rights laws." The 1992 Revised ALTA Loan Policy (10-17-92) refined the *Durrett* exception to exclude "[a]ny claim, which . . . by reason of the operation of federal bankruptcy, state insolvency, or similar creditor's rights laws that is based on: (a) the transaction creating the interest of the insured mortgagee being deemed a fraudulent conveyance or fraudulent transfer. . ."

sales either do not participate at all or discount their bids to account for the risk that the purchase may be avoided in bankruptcy.[11] This results in fewer value-maximizing sales to third parties, and the foreclosing lender more frequently acquiring the property.[12] The lender must then incur the often substantial carrying and resale costs of "Real Estate Owned." The lender who purchases at foreclosure may be compelled to warehouse the property until it is certain that no action can be filed under section 548. During this period, the lender suffers further lost income on the nonproducing loan and must pay all the normal holding costs such as taxes, insurance, and the cost of repairs to preserve the security. An unoccupied property may be subject to vandalism resulting in substantial additional costs. In the commercial or multifamily context, these maintenance and carrying costs can be particularly burdensome.[13] Like any other cost of doing business, the

[11] *See e.g. In re BFP*, 974 F.2d 1144, 1148 (9th Cir. 1992); *Abramson v. Lakewood Bank & Trust*, 647 F.2d 547, 550 (5th Cir. 1981) (dissenting opinion), *cert. denied*, 454 U.S. 1164 (1982); *In re Winshall Settlor's Trust*, 758 F.2d 1136, 1139-40 (6th Cir. 1985); *In re Gilmore*, 31 B.R. 615, 618 (E.D. Wash. 1983); *In re War Eagle Floats, Inc.*, 104 B.R. 398, 401 (Bankr. E.D. Okla. 1989; *In re Ristich*, 57 B.R. 568, 577 (Bankr. N.D. Ill. 1986); *In re Alsop*, 14 B.R. 982, 987 (Bankr. D. Alaska 1981).

[12] Critics of state law postforeclosure redemption periods have observed the same phenomenon. *See* E. Murray, *Statutory Redemption: The Enemy of Home Financing*, 28 Wash. L. Rev. 39, 40 (1953).

[13] If the property is a hotel, nursing home, apartment complex, office building, factory or other ongoing business, the foreclosing lender may be obliged to operate the business to prevent deterioration of the collateral pending resale. In addition to the expense of funding operating shortfalls, the lender may face other difficulties. The business may be subject to state and/or federal regulation. Operation of the foreclosed property may result in unexpected tax consequences such as subjecting the lender's entire portfolio within the state to state tax. A mortgagee operating foreclosed property may in some states be required to qualify to do business in that state. If that is not possible for an out of state bank, then the mortgagee may have to engage a trust company to operate the property, or develop an alternative arrangement to avoid doing business illegally. *See* R. Lifton, *Real Estate in Trouble: Lender's Remedies Need an Overhaul*, 31 Bus. Law. 1927, 1940-41 (1976).



increased costs of foreclosure associated with the *Durrett/Bundles* rule must ultimately be passed onto the consumers of mortgage loans.[14]

In the post-*Durrett* world, the acquiring party at a foreclosure sale may be taking a substantial risk if he resells prematurely. Two particularly egregious cases illustrate this problem. In *Coleman v. Home Savings Association (In re Coleman)*, 21 3B.R. 832 (Bankr. S.D. Tex. 1982), the purchaser at foreclosure was a second mortgagee who purchased the property for the amount of its debt ($5,700) subject to a first mortgage. The second mortgagee then resold the property for $5,700, again subject to the first mortgage. The court determined that the value of the property was not less than $40,000, and found that a fraudulent transfer had occurred. The court indicated that in the event it was determined that the purchaser from the second mortgagee was a good faith purchaser, and that therefore the property could not be recovered pursuant to section 550(a)(1), then the second mortgagee would be liable for damages equal to the value of the property less its debt ($34,300). Similarly,

[14] Petitioner's amici rely on Professor Shuchman's article, *Data on the Durrett Controversy*, 9 Cardozo L. Rev. 605 (1987), to suggest that *Durrett* had no impact on credit markets. However, the Shuchman study has been criticized for being based on certain flawed methodology and the false assumption that *Durrett* would immediately manifest itself in higher interest rates, fewer loans, or reduced loan to value ratios. *See* R. Zinman, *Durrett Data: Shucking the Husks From the Grain*, 9 Cardozo L. Rev. 1013 (1988). The pricing, terms and conditions of mortgage loans are influenced by a myriad of factors. It is simply impossible to isolate the effects of any single factor. What is undeniable is that the *Durrett/Bundles* rule results in additional risk to lenders. *Cf.* Murray, *supra* at 41-42 (noting that Washington state redemption period had effect of diverting capital investment and altering the terms and conditions of mortgage lending).

in *In re Lindsay*, 98 B.R. 983 (Bankr. S.D. Cal. 1989), the court found that the appropriate remedy where the first mortgagee had purchased the property at foreclosure for less than reasonably equivalent value and the property's value had declined following the sale, was for the first mortgagee to pay the balance owing on the junior lienor's note less the amount due on its own note.

*Coleman* and *Lindsay* are good examples of the foreclosure purchaser's predicament under the *Durrett/Bundles* rule. To make matters worse, there is little the purchaser at foreclosure can do to protect himself from this nightmare scenario. It is not enough to suggest that the buyer can assure himself of clear title by bidding at least 70 percent of fair market value or even full market value, for it is virtually impossible to predict what the value of the property will be determined to be with hindsight by a bankruptcy judge years later. Appraisals prepared by qualified and experienced appraisers often differ significantly. Even if the buyer believes he had obtained the best appraisal possible, or obtains multiple appraisals, the trustee in bankruptcy would not be precluded from challenging the foreclosure sale and engaging the buyer in a subsequent "battle of the appraisers." [15] Moreover,

[15] Accurate computation of reasonably equivalent value presents exactly the type of difficult factual determination that calls for the use of a conclusive rule. Where a factual determination is unwieldly, time-consuming, or results in unwarranted uncertainty, it is appropriate for the court to employ a conclusive evidentiary rule. *Cf. Arizona v. Maricopa County Medical Soc.*, 457 U.S. 332, 344-48 (1982) (reversing court of appeal's order for a full factual inquiry into purpose and effect of alleged price-fixing arrangement under antitrust law, and commenting that "[f]or the sake of business certainty and litigation efficiency, we have tolerated the invalidation of some agreements that a fullblown inquiry might have proved to be reasonable.") Conclusive rules are particularly appropriate in bankruptcy proceedings where prompt, efficient, low-cost resolution of disputes is desirable. *See e.g. Drabkin v. A.I. Credit Corp.*, 800 F.2d 1153, 1157 (D.C. Cir. 1986) (presumption that prepetition payments to undersecured creditor are applied to the unsecured portion of the creditor's claim "is properly treated as conclusive



even if the purchaser could determine fair market value with certainty, most courts reject talismanic adherence to the "bright line" 70 percent rule, and following *Bundles* believe they must review all the facts and circumstances on a case by case basis to determine reasonably equivalent value. Thus, absent the *Madrid* rule, it is virtually impossible to determine at the time of foreclosure whether the sale can withstand a section 548 challenge.

Nor do the protections of sections 548(c) and 550 mitigate the negative effects of the *Durrett/Bundles* rule. Under section 548(c), the good faith purchaser at a foreclosure sale is given a lien on the property recovered by the trustee to the extent it gave value to the debtor.[16] Under section 550(d), the good faith transferee has an additional lien on the property to secure the lesser of the costs of any improvements it made or any resulting increase in the value of the property. "Improvements" include physical additions, repairs, taxes, payments to superior lienholders, and the costs of preserving the property.[17] A trustee may not recover from a subsequent good

and not subject to rebuttal. . ."); *Bakst v. Vono (In re Gold Rush East)*, 55 B.R. 126, 127 (Bankr. S.D. Fla. 1985) (failure to comply with state law bulk transfer rules raises conclusive presumption of fraud).

[16] Section 548(c) provides:

> (c) Except to the extent that a transfer or obligation voidable under this section is voidable under section 544, 545, or 547 of this title, a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.

11 U.S.C. section 548(c).

[17] Section 550(d) provides:

> (d)(1) A good faith transferee from whom the trustee may recover under subsection (a) of this section has a lien on the property recovered to secure the lesser of—

faith transferee who takes the property for value and without knowledge of the voidability of the transfer. 11 U.S.C. section 550(b).

These statutory liens do not adequately protect the foreclosure sale purchaser. In a declining real estate market, the value of the property may go down despite any improvements. In that case, giving the initial transferee a lien is no protection at all. *See Lindsay*, 98 B.R. at 992. Even if the market value of the property remains stable between acquisition and avoidance, the transferee who improves the property could lose his investment if the bankruptcy court were to determine that the value added to the property by the improvements was less than their cost. *See In re General Industries, Inc.*, 79 B.R. 124, 137 (Bankr. D. Mass. 1987) (creditor given section 550(d) improvements lien for roof repairs equal to only one half of the actual cost of those repairs).

More importantly, the statutory liens fail to remedy the practical negative effects of the *Durrett/Bundles* rule. In particular, section 550 does nothing to counteract the disincentive to third party purchasers. What individual seeking a home for his family would bid on a property being sold at foreclosure knowing that he might have to return it years later, or pay out the difference between its "true

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(A) the cost, to such transferee, of any improvement made after the transfer, less the amount of any profit realized by or accruing to such transferee from such property; and

(B) any increase in the value of such property as a result of such improvement, of the property transferred.

(2) In this subsection, "improvement" includes—

(A) physical additions or changes to the property transferred;

(B) repairs to such property;

(C) payment of any tax on such property;

(D) payment of any debt secured by a lien on such property that is superior or equal to the rights of the trustee; and

(E) preservation of such property.

11 U.S.C. section 550(d).



value" and the price he paid plus the value of improvements? Likewise, no rational investor would buy a property at foreclosure just so that he can have a lien on the property or the improvements. Rather, investors buy properties at foreclosure for their "upside" potential. As long as that potential is threatened by section 548, value-maximizing foreclosure sales to third parties will be rare indeed. As the Ninth Circuit commented in declining to apply state foreclosure redemption periods to FHA foreclosures,

> What third party would bid and pay the full market value, knowing that he cannot have the property to do with as he wishes until a set period has gone by, and that at the end of the period he may not get it, but instead may be forced to accept a payment which may or may not fully reimburse him for his outlays?

*United States v. Stadium Apartments*, 425 F.2d 358, 365-66 (9th Cir. 1970).

## III. THE *DURRETT/BUNDLES* RULE UNDERMINES THE PURPOSE OF SECTION 548 AND RESULTS IN INCONSISTENCY WITHIN THE BANKRUPTCY CODE.

Applying section 548 to noncollusive regularly conducted foreclosure sales undermines the recovery of equity which is the objective of section 548. As noted above, due to the uncertainty of title acquired through foreclosure, potential buyers at foreclosure sales may discount their bids further than they otherwise would, value-maximizing sales to third parties are less frequent, and mortgagees are more likely to be the successful bidders. Perversely, such a result almost guarantees that any equity that may have been present will be lost.

The *Durrett/Bundles* rule is inconsistent with Bankruptcy Code policy and provisions that protect the rights of secured creditors. In fact, the *Durrett/Bundles* rule creates the anomalous result that a secured creditor may

be in a worse position than if the foreclosure had not been completed before the debtor filed its bankruptcy petition. If the borrower files a bankruptcy petition on the eve of foreclosure, as frequently is the case, then the foreclosure proceedings are automatically stayed pursuant to 11 U.S.C. section 362. Under section 506(b), to the extent the value of his collateral exceeds the amount of his claim, a secured creditor is entitled to postpetition interest on his claim, as well as any reasonable fees, costs or charges provided for under his security agreement. *See* 11 U.S.C. section 506(b). However, if the debtor files its petition after foreclosure and subsequently mounts a successful section 548 challenge, the foreclosure is retroactively void, but the secured creditor is not restored to the same position he would have been in if the foreclosure had not taken place.

In the event that a transfer is avoided under section 548, then a trustee or debtor-in-possession may recover for the estate "the property transferred, or, if the court so orders, the value of such property . . ." 11 U.S.C. section 550(a). If the foreclosure had not occurred, then the oversecured creditor would have been entitled to a lien for the full amount of the debtor's obligations under the applicable loan documents, including continued accrual of interest, default interest and other chargeable items. However, if a foreclosure is avoided under section 548, and the court chooses the remedy of a money judgment, then in addition to being required to pay the difference between its bid price and the court's estimation of value, the hapless secured creditor who has resold the property for a loss, appears also to lose the interest and other items to which it would have been entitled in bankruptcy, if the foreclosure had not occurred. Likewise, where the court chooses the remedy of reconveying the property to the debtor, the oversecured creditor does not receive the same bankruptcy protections that it would have received if the foreclosure had not occurred. As discussed above, the section 550(d) lien is often inadequate to compensate the secured creditor for carrying costs and other improvements. Moreover, the section 548(c) lien



only covers the value given, i.e. the bid price at foreclosure which is rarely 100 percent of the amount of the secured creditor's claim. Finally, in at least one case, the bankruptcy court ordered reconveyance of the property but deprived the secured creditor of interest accruing in the gap period between foreclosure and reconveyance. *See In re General Industries, Inc.*, 79 B.R. 124, 137 (Bankr. D.Mass. 1987). Fairness and consistency within the Bankruptcy Code mandate that the oversecured creditor's interests should be equally protected regardless of whether the foreclosure sale is avoided. If the *Madrid* rule were followed, these unfair and anomalous results would not occur.

Recent decisions of this Court interpreting the Bankruptcy Code recognize and protect both the secured creditor's "bargained for" right to foreclose and his secured interest in any "equity cushion" above the amount of his claim. In *Dewsnup v. Timm*, —— U.S. ——, 112 S.Ct. 773 (1992), a Chapter 7 debtor, whose bankruptcy petition had stayed the mortgagee's attempts to foreclose on certain real estate, asserted that under section 506(d) of the Bankruptcy Code, the creditor only retains a lien up to the value of the property securing the debt. The bankruptcy court held a valuation hearing, and agreed with the debtor that the lien for the amount above the value of the property is void.[18] Recognizing the ambiguity of the term "secured claim" in section 506(d), this Court rejected the debtor's argument, and protected the secured creditor's "bargained for" lien on the amount of value exceeding its debt:

> The practical effect of petitioner's argument is to freeze the creditor's secured interest at the judicially determined value. By this approach, the creditor would lose the benefit of any increase in the value of the property by the time of the foreclosure sale. The increase would accrue to the benefit of the debtor, a result some of the parties describe as a "windfall."

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[18] Section 506(d) provides, in pertinent part, that "[t]o the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void. . ."

> We think, however, that the creditor's lien stays with the real property until the foreclosure. That is what was bargained for by the mortgagor and the mortgagee. . . . Any increase over the judicially determined valuation during bankruptcy rightly accrues to the benefit of the creditor, not to the benefit of the debtor and not to the benefit of other unsecured creditors whose claims have been allowed and who had nothing to do with the mortgagor-mortgagee bargain.

*Dewsnup,* —— U.S. ——, 112 S.Ct. at 778. Similarly, in *Nobelman v. American Savings Bank,* —— U.S. ——, 61 U.S.L.W. 4531 (U.S. June 1, 1993) (No. 92-641), this Court held that "cram down," or the reduction of a secured claim to the value of the collateral, may not be imposed under a Chapter 13 plan because the mortgagee's bargained for right to repayment in accordance with the relevant mortgage instruments is protected in Chapter 13. Permitting bankruptcy courts to set aside noncollusive regularly conducted foreclosure sales is inconsistent with the clear thrust of these cases interpreting the Bankruptcy Code to preserve the bargained for rights and remedies of mortgagors and mortgagees.

## IV. THE *DURRETT/BUNDLES* RULE IS UNNECESSARY TO PRESERVE EQUITY AND WASTES JUDICIAL RESOURCES.

The petitioner's amici assert that in the typical foreclosure sale, the mortgagee purchases the property for a nominal price and reaps a "windfall" on resale. They further contend that the purchasing mortgagee then realizes a "double recovery" by obtaining a deficiency judgment. This alleged result is, in their view, a common occurrence due to the failure of state foreclosure procedures to optimize sale prices, and one which Congress intended to remedy through section 548.

The contentions of petitioner's amici are completely at odds with reality. Freddie Mac's experience does confirm that in today's foreclosure market, the mortgage lender



is almost always the purchaser at foreclosure sales. However, this has little to do with any perceived inadequacy of state foreclosure laws. Rather, it reflects the fact that if there had been any equity in the property, the debtor would have refinanced the property, or others would have out bid the mortgage lender, and any excess would have gone to junior lienors or to the mortgagors. *See United States v. Stadium Apartments, Inc.,* 425 U.S. at 366.

Based on amicus Freddie Mac's experience, the reality of foreclosure is that the purchasing mortgagee rarely, if ever, acquires a property that can be resold for an amount that exceeds its debt and the costs of sale. There are simply no windfall profits in the resale of foreclosed property. In 1992, Freddie Mac disposed of 6,630 single-family houses, with an average loss per property of $23,882. On average, Freddie Mac held these properties for 158 days before resale. In the multifamily area, Freddie Mac resold 156 apartment complexes in 1992 for an average loss per property of $792,110. On average, Freddie Mac held foreclosed multifamily properties in 1992 for 418 days before resale.[19]

Many factors combine to increase the loss to mortgagees on resale. Often, properties that are acquired at foreclosure have been neglected by the mortgagor and require substantial repairs. Carrying costs during the holding period such as taxes, insurance, and other expenses of preserving the collateral may be substantial. *See* Part II, *supra,* at p. 14. As the seller of real estate, the mortgagee is required to pay all the normal costs of sale including marketing costs, broker's fees, and loan points. Knowledge by potential purchasers that the property is owned by a mortgage lender generally results in relatively low offers.

Avoiding a regularly conducted noncollusive foreclosure sale through section 548 is unnecessary to protect any

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[19] *See* Federal Home Loan Mortgage Corporation, Information Statement Dated April 9, 1993, p. 34.

equity that the debtor may have in the property. Typically, there is a considerable time period between default and foreclosure. For example, Freddie Mac does not normally initiate foreclosure proceedings on single family mortgages until a mortgage has been delinquent for at least 90 days. During that period, the borrower will have received numerous notices from the servicer. Virtually all state foreclosure laws provide for a substantial preforeclosure redemption period durir.g which the debtor may redeem the property by full payment of the outstanding indebtedness. Further, state foreclosure schemes provide for additional notices to the borrower, including, in some states with judicial foreclosure procedures, a requirement of time-consuming court proceedings at several stages of the foreclosure process. In addition, all state foreclosure laws require substantial time periods for public advertising. The result is that a borrower in default of his mortgage typically has many months in which to negotiate a workout with his lender, to refinance, or to sell the property. Clearly, the default and foreclosure process provides an adequate opportunity for the borrower to salvage any perceived equity.

The application of section 548 to a properly conducted noncollusive foreclosure sale does not assist in recovering this alleged equity, but only wastes judicial resources by needlessly multiplying litigation. A foreclosure sale may always be challenged in a state court proceeding, as occurred in the case at bar. Moreover, in states which utilize the deed of trust, the disappointed borrower has the further remedy of a fiduciary liability suit against the trustee. The trustee under a deed of trust has under a fiduciary duty to take reasonable and appropriate steps to avoid sacrifice of the debtor's property and his interest. *McHugh v. Church*, 583 P.2d 210, 214 (Alaska 1987); *Fralin v. Aronovich*, 247 F.2d 468, 471 (4th Cir. 1957). Allowing a bankruptcy court to unwind a valid noncollusive foreclosure sale through section 548 gives the borrower an unwarranted "second bite



of the apple" resulting in negative repercussions for all participants in the mortgage industry—consumers and producers alike.

## CONCLUSION

It makes good sense to conclude as both the Ninth and Sixth Circuits have done that the "reasonably equivalent value" of real estate sold at a regularly conducted noncollusive foreclosure sale is the price received at that sale. Such a rule promotes the important policy of certainty and finality in real estate transactions, is consistent with recent decisions of this Court, conserves judicial resources, and avoids anomalous results and negative economic consequences. Accordingly, the decision of the Ninth Circuit below should be affirmed.

Respectfully submitted,

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